

STATEMENT BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE

October 24, 2001

PROTECTING POLICYHOLDERS FROM TERRORISM: PRIVATE SECTOR SOLUTIONS

On Behalf of the Following Associations and their Members:

**American Council for Capital Formation
Associated General Contractors of America
American Resort Development Association
Building Owners and Managers Association International
International Council of Shopping Centers
Mortgage Bankers Association of America
National Apartment Association
National Association of Industrial and Office Properties
National Association of Real Estate Investment Trusts
National Association of Realtors
National Multi Housing Council
Pension Real Estate Association
The Real Estate Board of New York
The Real Estate Roundtable**

Mr. Chairman, we commend you and the Committee for the much-needed attention that you are bringing to this important issue by holding a hearing today. You clearly recognize the importance of this issue and its potential effect on the U.S. economy. We thank you for your leadership in addressing insurance-related problems as a result of the events of September 11, and we also appreciate the White House efforts to remedy a potential insurance coverage crisis. The real estate and construction industries, which account for over a quarter of the nation's gross domestic product, could face severe economic dislocation in the coming months if the federal government does not immediately address insurance-related issues tied to terrorism.

To continue to operate in the normal course of business, these industries need to continue to have insurance for risks that have traditionally been insurable, including damage associated with terrorism. The insurance industry recently testified before the full Committee that without Federal support, it will not be able to provide terrorism coverage in the future. Further, as the nation expands its mission against terrorism, the line between terrorism and war will likely become increasingly blurred from an insurance standpoint.

The Problem

On September 26, the CEOs of several major insurance companies testified before your committee that the insurance industry expects to be able to pay claims associated with the September 11 terrorist attacks. However, they also said that insurers would not be able to provide terrorism coverage for future terrorist acts. The reason is that reinsurance for terrorist risks is generally unavailable in the current marketplace.

We take the insurance industry's warnings seriously and the Congress must as well. The lack of adequate reinsurance in the current market means that coverages our members need could very soon become unavailable to large segments of the U.S. economy. A significant percentage of owners of commercial properties open to the public, including shopping centers, offices, apartments and hotels, renew their insurance coverage on January 1 of each year. Many construction projects, including a number of new power plants, are slated to begin early and throughout next year. Many of the owners and developers already have been advised that their policies may not be renewed or that their new policies will exclude terror/war risks. Further, some owners have been

advised that their current coverage may be terminated before their policies were set to expire, after the insurers provide the required advance notice (usually 90 days).

On October 15, a senior Bush Administration official said: “Without coverage against terrorist acts, banks will not lend to new construction; it will be difficult to sell major projects such as new pipelines, new power plants, skyscrapers. So we do think there is a problem that needs to be addressed.” We could not agree more.

Mr. Chairman, the property owners among our members (including many pension funds that provide retirement security for their workers and families) cannot buy, sell, or finance the acquisition or construction of a commercial building unless it is covered by adequate insurance. Before September 11, adequate insurance was readily available. Neither property nor general liability policies in the U.S. excluded losses stemming from terrorist attacks. They excluded only acts of war. It now appears that terrorism coverage will not be available and that war risk coverage, which did not previously seem imperative, is now necessary to the extent any future attacks could be viewed as war-related.

The real estate and construction industries are leading pillars of the U.S. economy. Without adequate insurance, it will be difficult, if not impossible to operate or acquire properties, to construct new properties, to refinance loans, or sell commercial mortgage-backed securities (of which \$350 billion is currently outstanding). Disappearance of coverage for terrorist acts could severely disrupt the U.S. economy.

The effects on our members of losing their insurance coverage are potentially severe. First, building owners and operators will be fully exposed to property damage losses from terrorist attacks and will be powerless to do anything about it. Worse, some

state insurance regulators may not permit insurers to exclude terrorism coverage, raising the possibility that insurers will withdraw completely from such states and leave our members without any coverage at all.

Second, our members will also be exposed to third-party liability claims for terrorism and war risks. Without adequate insurance, they will be forced to choose between incurring these risks or closing their buildings to avoid them.

Third, virtually all of our members have clauses in their financing agreements requiring that minimum levels of insurance coverage on the property be in place. Without the required coverage, lenders would be free to foreclose because the loan would be in default without required insurance. Even more importantly, without adequate insurance coverage, lenders would not approve new loans to finance new construction or property sales, or refinance existing debt. This lack of liquidity could lead to the same severe problems the real estate and construction industries confronted after the savings and loans crisis when property values fell more than 30% largely because sources of capital dried up. Any similar liquidity crunch could have severe consequences on employment and state and local property and sales tax collections.

Further, portfolio lenders would be confronted with the possibility of limiting operations. The ability to finance commercial real estate transactions by institutional investors such as pension funds and life insurance companies would be at risk. These mortgage lenders have a fiduciary duty of prudence in investing money, and investing funds without adequate insurance would breach this duty. A lender refusing to make a loan without adequate insurance is not being arbitrary, it is acting in the best interest of the investor, whose money the lender is investing.

Fourth, the property owners among our members are likely to find that they cannot complete their construction projects, or begin new projects, until terrorism coverage can be restored. Lenders are unlikely to approve construction loans until our members can obtain builders risk insurance that is broad enough to cover acts of terrorism. This will affect not only our members, but also the U.S. economy as a whole. As you know, the construction industry is enormous and our economy was already struggling at the time of the terrorist attacks. The volume of construction that our members were putting into place had already begun to decline. Without government action to resolve this insurance problem, many construction workers are at risk of layoffs.

Fifth, apartment residents would see higher housing costs as real estate operating costs would increase significantly in the absence of continuing coverage of acts of terrorism. Even before September 11, multifamily owners and operators were facing year-over-year increases of 25-100% in their property and casualty insurance costs. Typically, these significant operating cost increases are reflected in higher market rents, especially in major urban markets with strong renter demand. In the absence of federal government involvement to provide for continuing coverage of terrorist acts, apartment renters, many of them low- and moderate-income families, will be forced to absorb a disproportionate share of heightened insurance costs and more-limited coverage. Federal government risk-sharing and the continued provision of coverage for acts of terrorism are needed to help moderate the impact on housing costs that renters will face as a result of the events of September 11.

Sixth, loss of coverage may lead to an increase in the cost of mortgage financing, especially in the commercial mortgage-backed securities (CMBS) market, as the result of

an additional, difficult-to-quantify catastrophic risk to the real estate assets serving as security for the CMBS offerings. CMBS offerings are usually priced in the same manner as bonds and other fixed-income securities, heavily dependent on credit ratings issued by the major securities-ratings agencies. The rating agencies, and the fixed-income investment community in general, are very sensitive to any possible circumstances that could impair the cash flow available for payment of the securities in question. Of course, uninsured damage caused by terrorism could, as we have all seen, terminate, interrupt, or otherwise materially impair cash flow; that risk would loom particularly large to the extent that it is difficult to quantify.

An increase in the cost of mortgage financing could, in turn, cause otherwise viable projects not to be undertaken, and reduce income throughout the industry, leading to further lessening of demand and economic activity.

The war exclusions that have been included in our members' insurance policies for years mean that our members have always been exposed to losses resulting from acts of war. They cannot purchase war risk coverage separately in the market. This has not previously been a major concern because it was thought that the likelihood of losses related to acts of war on U.S. soil were quite remote. However, the events of September 11 and subsequent U.S. military activities in Afghanistan will cause the property owners among our members, and possibly their lenders, to reconsider whether it is acceptable to be exposed to such risks. The line between acts of war and acts of terrorism is in danger of blurring and our members cannot afford to be exposed to either risk. Henceforth, they must have adequate insurance protection for both risks. As of now they do not.

With many real estate businesses facing insurance policy cancellations and modifications on or before January 1, and both power plants and other construction projects ready to begin, the government must act now. Without government action, our industries will likely face the prospect of breaking promises to lenders, partners and others, of operating without necessary insurance coverage, and of watching the construction of new facilities slow down. Since operating a business without adequate insurance in many cases is not feasible, and is certainly unwise, real estate businesses will confront the possibility of ceasing or limiting operations until insurance once again becomes available. Without Federal action, the ability to finance, construct, buy or sell properties across the nation may be at risk.

Proposed Solution

We understand that the Subcommittee will wish to ensure that the Federal government does not take action that will ultimately interfere with or displace the private insurance markets. We share that concern. However, it is not clear when, or if, the private insurance markets will be able to meet our members' needs for terrorist insurance coverage.

The Federal Government must play a role in ensuring that commercial property owners can continue to obtain coverage for damage for acts of terrorism. This is especially true in the near-term while we wait to see whether and how the private markets will adjust to the new post-September 11 realities and risks. Further, given the increasing possibility that a court could conclude that future damages caused by a terrorist actions is excludable as damages resulting from a state of war, the Government must also play a

role, at least in a standby capacity, in ensuring the availability of coverage for damages arising from the actions undertaken by terrorists such as al Qaeda or their allies.

There is ample precedent for the Federal Government filling the insurance or reinsurance gap: (1) crime and riot insurance programs were created for urban business owners following the social unrest of the late 1960s and early 1970s; (2) flood and crop failures are insured under Federally sponsored programs; (3) standby war risk coverage already exists for certain aviation and maritime operations (including a post-September 11 expansion of the aviation war risk program); and (4) during World War II, the Government authorized a program, administered by private insurers, which insured property against “enemy attack.”

The insurance industry has put forward a proposal to establish a special, state-chartered reinsurance company that would accept terrorist risks from companies wishing to cede risks to it. That company would then reinsure 95% of these terrorism risks to the federal government. That proposal builds upon a model in the United Kingdom where a special reinsurance pool for terrorist risks was created in the early 1990s in the wake of IRA bombings in the City of London. The U.K. Government provides a backstop to that pool, but has not been called upon to pay any losses to date.

The Bush Administration has outlined a proposal to deal with the current problem that would involve a three-year program under which the Federal Government and the insurance industry would share, in declining proportions each year, the risks of terrorist acts. While the details of this proposal must be made clear, including the scope of acts covered within the definition of terrorism, we believe it represents a positive step towards addressing this issue.

We commend both proposals to your careful consideration. In the end, however, we emphasize that the problem must be addressed in a satisfactory and timely manner. A critical criterion in measuring the effectiveness of any solution is whether the financial community will continue to provide capital necessary to buy, sell, construct or refinance properties. Since real estate is a long-lived asset, real estate financing tends to be long-term. Accordingly, the finite duration of federal involvement must not prevent lenders from making these long-term commitments. Further, the insurance industry's primary coverage should not be rendered immaterial by unrealistic retention amounts (*i.e.*, deductibles) imposed on insureds.

The Congress must not fail to act. The real estate and construction industries welcome the opportunity to work with the Administration and Congress to achieve a workable solution to this immediate problem this year. To discuss these issues in greater detail, please contact Tony Edwards at NAREIT at (202) 739-9400 or tedwards@nareit.com or Chip Rodgers at The Real Estate Roundtable at (202) 639-8400 or crodders@rer.org.